Negotiability as a System of Title Recognition*

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I. INTRODUCTION

Negotiable instruments law is a subject that has received relatively little serious attention in the recent past. When the Uniform Commercial Code (U.C.C.)[1] was drafted in the 1940s, other areas of commercial law such as sales and secured transactions were subjected to thorough reexamination and reconceptualization. The results of that work, Articles 2 and 9, would probably be regarded by most as relatively successful efforts to develop suitable bodies of law for modern transactions. The law of negotiable instruments, on the other hand, seems to have received relatively little attention in the U.C.C. project. Article 3 is really only a reworking of the Uniform Negotiable Instruments Law,[2] most of the changes being largely matters of drafting style and organization. Certainly no one would suggest that Article 3 sought to revolutionize the law in the manner that Article 9 reordered the legal categories of secured financing—presumably because no one thought that there was any need for any fundamental reexamination of the law of negotiable instruments.

The attitude of scholars toward Article 3 seems to bear out the assumption that all of the really interesting issues about negotiable instruments law were resolved long before the adoption of the U.C.C. There has, of course, been a steady stream of narrow and highly technical writing on various points in Article 3, but little if any major theoretical, jurisprudential, or empirical work.[3] Rather, Article 3 has quietly settled in as an area of law that is likely to be of interest only to a peculiar sort of

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1. AMERICAN LAW INSTITUTE & NATIONAL CONFERENCE OF COMMISSIONERS OF UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE: 1972 OFFICIAL TEXT WITH COMMENTS [hereinafter U.C.C.]. Because the 1977 amendments concerning uncertificated securities have not yet been widely adopted, *see infra* note 47, and because the focus of this Article is the paper-based system of negotiable instruments law, citations herein will be to the 1972 version of the U.C.C. unless otherwise noted.

2. The Uniform Negotiable Instruments Law [hereinafter N.I.L.] (*reprinted in* J. OGDEN, THE LAW OF NEGOTIABLE INSTRUMENTS 712–56 (5th ed. 1947)) was promulgated by the National Conference of Commissioners on Uniform State Laws in 1896, and by 1924 had been enacted in all American jurisdictions. W.E. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES §3, at 16–17 (1943). The N.I.L. was later withdrawn by the National Conference of Commissioners in 1951 having been superseded by the U.C.C. HANDBOOK OF THE NAT'L CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS AND PROCEEDINGS OF THE ANNUAL CONFERENCE MEETING IN ITS NINETY-SECOND YEAR 290, table IV (1983).

3. White and Summers note that "[s]cholars . . . are today neglecting Article Three of the Code on commercial paper." J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 486–87 (2d ed. 1980).

Perhaps the only real exceptions are Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 376 (1971), and Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441 (1979). Although both of these articles contain intriguing suggestions that perhaps the whole concept of negotiability is an outdated relic, they seem to have had relatively little effect on the scholarship or teaching of commercial law. Instead, it has simply become customary to include an excerpt from one or the other of these in the introductory section of teaching materials on Article 3, and then plow ahead with the dreary task of learning all the arcane rules.

academics who, in a different age, might have devoted themselves to philology or some other such harmless pursuit.[4]

A premise of this Article is that there is a genuine need for a thorough reexamination of the basic concepts and assumptions of negotiable instruments law. This Article attempts one part of that task[5] by examining an aspect of negotiable instruments law that would probably be regarded by lawyers as among the most well-settled principles of commercial law: the principle that by virtue of the holder in due course rules a bona fide purchaser of a negotiable instrument takes it free from all adverse claims.[6] The applicability of this rule is often taken as the principal

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4. To be sure, in the 1970s there was considerable dispute about the role of the holder in due course doctrine in consumer finance, and more recently there has been quite a bit of activity concerning the extent to which the evolution of non-paper based forms of instruments may require modifications of negotiable instruments law. None of this activity, however, has been thought to require any real rethinking of the basic concepts of negotiable instruments law. Throughout the dispute over the holder in due course doctrine in consumer finance, it was always assumed that the doctrines of negotiable instruments law were sensible and important in their proper spheres. The task was only to separate out consumer transactions for different treatment. Similarly, discussion about the need for new bodies of law to cover electronic funds transfers and other new payments systems has generally proceeded on the assumption that the law of negotiable instruments is well-adapted to the check system and that the problems are created only by the development of new technologies.

5. One productive approach to the assessment of the modern significance of negotiable instruments law would be to examine typical modern transactions in which writings classified as negotiable instruments are used. These transactions would be examined in order to determine whether the commercial practices involved actually correspond to the traditional assumptions of negotiable instruments law and whether the doctrines and concepts of negotiable instruments law really provide a useful framework for resolution of the legal problems involved in the transactions. For such an effort in the field of the check based payment system, see Rogers, *The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System*, 65 Tex. L. Rev. 929 (1987).

This Article, however, adopts a slightly different approach. It accepts, for purposes of argument, that there are transactions in which negotiable instruments are transferred from party to party and assesses the utility of negotiable instruments law as a system for resolving the disputes as to ownership and other interests in such instruments that would arise in such transactions. It may, though, be worth noting briefly that the traditional assumption that there are widespread practices of frequent transfers of negotiable instruments is rather questionable in the modern world. For example, although hypotheticals in commercial law texts often involve transactions in which notes or other instruments issued in mercantile transactions among businesspeople are transferred to others, it is hard to see where the notes or other credit instruments that would be used in such transfers are supposed to come from. For at least the last hundred years or so, American businesspeople have not commonly used *any* written credit instruments in ordinary credit sales. Credit sales among businesspeople are, of course, routine, but they are almost invariably conducted on an open account basis. *See, e.g.*, R. Soldofsky & G. Olive, Financial Management 447–52 (1974). Around the time of the Civil War the use of open book credit, with relatively short credit periods and a discount for cash payment, largely displaced the earlier practice of selling on long credit terms represented by notes or acceptances. *See, e.g.*, B. Klebaner, Commercial Banking in the United States: A History 80 (1974); G. Porter & H. Livesay, Merchants and Manufacturers 125–27 (1971).

6. This Article does not consider the freedom from defenses aspect of negotiability. Although interesting issues are involved in the matter of the suitability of the freedom from defenses aspect of the holder in due course rules in modern transactions, there is good reason to believe that the freedom from claims aspect is today a more significant concern in the assessment of negotiable instruments law. In the first place, the most common instance in which the freedom from defenses aspect of negotiability doctrine has come into play in recent years was the consumer finance setting, *see, e.g.*, Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967), and that problem has become moot since the 1975 promulgation of the Federal Trade Commission rule effectively abolishing holder in due course status for notes issued in consumer transactions, Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433 (1985). Moreover, the instruments that are most likely to be the subject of significant trading, such as corporate securities or various forms of money market instruments, are likely to have been issued in transactions that are unlikely to give rise to any significant possibility of defenses to the obligor's obligation. If an instrument is issued for a simple loan of money, as distinguished from issuance of instruments in exchange for promises of goods or services, as in the consumer settings in which the freedom from defenses issue became significant, there is really not very much for the obligor to dispute in an action on the instrument—either the obligor did or did not get the money!

Occasionally, however, the conviction that negotiability must be important, coupled with a confusion between defenses to the loan itself and defenses that might arise in the transaction in which the proceeds of a loan are used, drives someone to find a role for the freedom from defenses notion even in corporate securities. A standard treatise on Article distinguishing feature of negotiable instruments; indeed, the word "negotiable" is often used in legal discourse as synonymous with the freedom from claims rules, as, for example, in statements such as "goods are less negotiable than investment securities." Reevaluation of this aspect of negotiable instruments law is particularly needed. The belief that negotiable instruments law is an important, though noncontroversial, area of the law is probably attributable in large measure to the assumption that the concept of negotiability, in the sense of freedom from adverse claims, has stood the test of time as a method of resolving the perennial problem of allocation of losses among several innocent parties victimized by thieves and other scalawags.

At the outset, it may be well to identify the distinguishing characteristics of negotiable instruments. Holdsworth's classic discussion of the development of negotiable instruments law suggests that there are three essential characteristics of negotiability: First, negotiable instruments are transferable; Second, consideration is presumed; and Third, a bona fide purchaser can acquire good title even from a thief.[7] For present purposes, the presumption of consideration is not significant.[8] The other two characteristics, however, warrant further explanation.

The proposition that negotiable instruments are transferable is, in one sense, trivial in modern law. At the time when English negotiable instruments law developed, it may well have been the case that a principal role of negotiable instruments law was to make debt instruments legally transferable.[9] It was generally said to have been the case that at common law choses in action were not assignable.

8, for example, suggests that without negotiability the issuer of a security might be able to "raise against the good faith purchaser any defect rising from the transaction financed by the issuance of the instrument." C. Israels & E. Guttman, Modern Securities Transfers ¶ 1.03, at 3 (rev. ed. 1971). That spectre, of course, is an absurdity in the usual case in which the securities are issued for cash and the cash used in some transaction. No one can defend against liability on any type of loan or investment by raising defects in the transaction in which the proceeds are used. To put it bluntly, "we did something foolish with the money" is not a defense to liability to repay a loan.

7. *E.g.*, 8 W. S. Holdsworth, A History of English Law 113–14 (1926).

8. The second characteristic listed above—that consideration is presumed—is essentially a matter of the independence of the liabilities of parties "on the instruments" from their liabilities arising out of the underlying transactions in which the instruments were given. In the usual case, of course, the point is not that there was no consideration given for the instrument, but rather that proof of the consideration—inquiry into the nature of the legal obligations incurred in the underlying transaction in which the instrument was used—is not required in order to establish a prima facie case.

9. Indeed, there is some reason to think that the simple matter of transferability was the essential characteristic of negotiable instruments in much of the history of Anglo-American negotiable instruments law. If one examines the cases cited in early treatises on negotiable instruments law dealing with the definition of "negotiable instrument," one finds that, in those cases in which there was a dispute about whether a given writing was a negotiable instrument, the issue was often simply whether a transferee of the instrument could bring suit in his or her own name. For example, an 1876 treatise cites 27 cases on the proposition that a negotiable instrument must contain a certain engagement to pay and the problem of the classification of IOU's. 1 J. Daniel, A Treatise on the Law of Negotiable Instruments §§ 35–38 (1876). Of these, only two involved efforts by one claiming holder in due course status to take free from claims or defenses. Franklin v. March, 6 N.H. 364 (1833); Sackett v. Spencer, 29 Barb. 180 (N.Y. Sup. Ct. 1859). In five of the cases the issue was simple transferability. Carver v. Hayes, 47 Me. 257 (1859); Brady v. Chandler, 31 Mo. 28 (1860); Marrigan v. Page, 23 Tenn. (4 Humph.) 246 (1843); Ellison v. Collingridge, 9 C. & B. 570, 137 Eng. Rep. 1014 (1850); Morris v. Lee, 2 Ld. Raym. 1396, 92 Eng. Rep. 409 (1725). In another five the issue was whether the instrument sufficed to trigger prima facie liablity without proof of consideration. Fleming, Linn & Co. v. Burge, 6 Ala. 373 (1844); Huyck v. Meador, 24 Ark. 191 (1866); Cummings v. Freeman, 21 Tenn. (2 Humph.) 143 (1840); Read v. Wheeler, 10 Tenn. (2 Yer.) 50 (1821); Allen v. Sea Fire & Life Assur. Co., 9 C. & B. 574, 137 Eng. Rep. 1015 (1850). Five others dealt with miscellaneous rules of pleading and procedure. Currier v. Lockwood, 40 Conn. 349 (1873); Brewer v. Brewer, 6 Ga. 587 (1849); Lowe v. Murphey, 9 Ga. 338 (1851); Hussey v. Winslow, 59 Me. 170 (1870); Russell v. Whipple, 2 Cow. 536

Today, of course, any simple monetary debt is freely assignable[10]—indeed, it is often not possible even by explicit contractual provisions to make a simple monetary debt non-assignable.[11]

The point of modern significance, then, is not the fact of transferability, but the meaning and method of transfer. No one, of course, would care much about transfers of negotiable instruments if all that were involved were ownership of pieces of paper. Rather, the point of having a transfer mechanism for negotiable instruments is to provide a mechanism for transferring the abstract rights embodied in the pieces of paper. The key element of the negotiability transfer system is that the liabilities of the parties to negotiable instruments are "reified" in the pieces of paper, that is, the writings become the indispensable embodiments of the liabilities of the parties. Accordingly, the appropriate way of transferring the rights embodied in the writings is by transferring the writings themselves.[12]

A major aspect of negotiable instruments law is the specification of rules concerning the method of transferring these writings. First, of course, there is the basic rule that possession of the writings is essential to transfer and recognition of interests. Not only must one who wishes to deal with the abstract right deal with the paper embodiment of that right, but one who wishes to deal with the paper embodiment must do so by possession.[13] More importantly, special rules, now found principally in Sections 3–202 and 3–204 on negotiation and indorsement, have evolved concerning the formal mechanism for transferring these writings.

Holdsworth's third characteristic, the proposition that a bona fide purchaser of a negotiable instrument can acquire good title even from a thief, points to the other major aspect of the negotiability transfer rules: specification of the rights of transferees. Indeed, as the common equation of the concept of negotiability with the

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(N.Y. Sup. Ct. 1824). Three were simply miscited. Biesenthall v. Williams, 62 Ky. (1 Duv.) 329 (1864); Fesenmeyer v. Adcock, 16 M. & W. 449, 153 Eng. Rep. 1265 (1847); Payne v. Jenkins, 4 Car. & P. 324, 172 Eng. Rep. 724 (1830). Ironically, in the largest group of the cases, seven, the issue of classification had virtually become an end in itself—the issue in those cases was whether the instruments were subject to stamp acts. Joacquin v. Warren, 40 Ill. 459 (1866); Little v. Slackford, 1 Mood. & Malk. 371, 173 Eng. Rep. 1120 (1828); Tomkins v. Ashby, 6 B. & C. 451, 108 Eng. Rep. 551 (1827); Childers v. Boulnois, Dowl. & Ry. 8, 171 Eng. Rep. 898 (1822); Israel v. Israel, 1 Camp. 499, 170 Eng. Rep. 1035 (1808); Fisher v. Leslie, 1 Esp. 426, 170 Eng. Rep. 407 (1795); Ruff v. Webb, 1 Esp. 129, 170 Eng. Rep. 301 (1794).

10. *See generally* 4 Corbin on Contracts §§ 856–73 (1951); Restatement (Second) of Contracts ch. 15, Introductory Note (1979).

11. *See, e.g.*, Restatement (Second) of Contracts § 322 (1979); U.C.C. § 2–210(2)("A right arising out of the assignor's due performance of his entire obligation can be assigned despite agreement otherwise."); U.C.C. § 9–318(4) ("A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account . . . or requires the account debtor's consent to such assignment . . . ."). In appropriate circumstances, though, a contractual restricton on assignment may be enforceable. For example, transfer restrictions in investment securities, for such purposes as ensuring compliance with federal securities laws governing unregistered securities, are generally enforceable. C. Israels & E. Guttman, *supra* note 6, at 55–56, ¶ 4.06.

12. Professor Clark refers to this technique as the "paperizing" principle. Clark, *Abstract Rights versus Paper Rights Under Article 9 of the Uniform Commercial Code*, 84 Yale L.J. 445 (1975). My indebtedness to Prof. Clark should be obvious, and is here acknowledged.

13. These two principles need not go together. For example, under Article 9, a security interest in goods covered by a negotiable document of title can be perfected by filing as to the goods (U.C.C. § 9–302) or by perfecting a security interest in the negotiable document, (U.C.C. § 9–304(2)), and a security interest in a negotiable document can be perfected by filing (U.C.C. § 9–304(1)) or possession (U.C.C. § 9–305).

freedom from claims rules suggests, the specification of the rights of transferees of negotiable instruments is the heart of negotiable instruments law.

The concept of negotiability, then, can usefully be thought of as a mechanism for the resolution of conflicting claims of ownership or other interests in the abstract rights to payment embodied in negotiable instruments. As such, the concept of negotiability serves a function similar to other legal techniques for the recognition of interests in property, such as the recording system or title registration systems for interests in realty, the filing system under Article 9 for security interests in personal property, or the certificate of title system for motor vehicles. For convenience, I shall herein refer to any such system as a title recognition system, although, of course, such systems typically govern interests of any sort in the property involved, rather than simply ownership interests.

Two assumptions about the negotiability system of title recognition lie at the heart of most lawyers' thinking about negotiable instruments law:

1. negotiable instruments are a very special form of property because the law provides greater protections to bona fide purchasers of negotiable instruments than to purchasers of any other form of property; and
2. this special protection of bona fide purchasers of negotiable instruments is important, nay essential, to those transactions in which negotiable instruments are used.

The point of this Article is to demonstrate that these assumptions are simply false. In many situations, the protection afforded to purchasers of negotiable instruments is exactly the same as that given to purchasers of any other form of property. Moreover, in many, if not most, modern transactions, the effect of the rules of negotiable instruments law is exactly the opposite of the usual assumption: The negotiability transfer rules ensure that claims of ownership will not be cut off, but will be enforceable even against a subsequent bona fide purchaser.

II. Negotiability and General Bona Fide Purchase Concepts

A lawyer asked to explain the existence of the holder in due course rule cutting off adverse claims is likely to respond by suggesting that, if it were not for the protections of this rule, purchasers of negotiable instruments would face a host of problems in seeking to fend off a wide variety of types of claims to the instrument that may have arisen during its peregrinations—someone might have stolen it, someone might have acquired some form of lien against it, someone might have transferred it in a transaction induced by fraud, mistake or the like, and so on. What is often overlooked, however, is that for a large class of such potential adverse claims, protection of purchasers of negotiable instruments from such risks neither requires nor justifies the existence of special rules for negotiable instruments.

Consider the class of claims that might be termed "secret equities." By this term, I mean the large and heterogeneous class of claims to property that would be recognized or created by a court of equity in the interest of doing justice between two immediate parties to a dispute and that might also be asserted against a subsequent holder of the property. Thus, one who loses property by fraud has the right to recover the property from the wrongdoer and might seek to enforce that claim against transferees from the wrongdoer.[14] Similarly one who has transferred property in a voluntary transaction may for some other reason—mistake,[15] material breach of contract,[16] or duress,[17] for example—have the right to rescind the transaction and recover the property from the immediate transferee, and perhaps might seek to enforce that claim against remote transferees. Another broad class of secret equities results from the application of the equitable maxim that equity regards as done that which should have been done. Thus, a court of equity might enforce an "equitable" mortgage, lien, or other interest in circumstances in which the parties intended to create an interest by the ordinarily proper mechanism but failed to do so.[18] One can imagine the beneficiary of such doctrines seeking to enforce the claim against subsequent transferees. The category of "secret equities," then, is as broad as the inclination of the courts of equity to lend their assistance to parties who have lost property, or failed to get property, by some misfortune or impropriety.

To be sure, if a purchaser of a negotiable instrument took the instrument subject to all such claims that may have arisen in any transaction in which the instrument was involved, the purchaser's title would be quite insecure. That insecurity might well have an effect on an individual's willingness to take transfers of negotiable instruments. Subjection to secret equities might then be a serious problem for purchasers of any type of property, negotiable or not. The problem, however, has long been resolved by general principles of bona fide purchase applicable to any form of property, negotiable or not. As a general principle of equity, any such equitable claims to recover property transferred in a voluntary transaction subject to rescission, or to enforce claims to property that were not in fact properly effectuated, are cut off if the property ends up in the hands of a bona fide purchaser.[19] Thus, the specter of subjection to a host of unknowable claims of rescission, equitable liens, and the like is a red herring in discussion of the holder in due course concept of the negotiability system. The problems are real, but they have already been solved, and negotiability adds nothing to the solution.

III. The Role of Possession in the Negotiability System of Title Recognition

Perhaps the key feature of the negotiability system of title recognition is the central role played by the concept of possession. As was noted above, the negotiability system of transferring interests in abstract rights to payment rests on two related principles: that the appropriate way of transferring the rights embodied in negotiable instruments is by transferring the writings and that the appropriate way of

14. *See generally* 1 G. Palmer, The Law of Restitution §§ 3.1–3.20 (1978).
15. *See generally* 2 *id.* §§ 11.1–11.6.
16. *See generally* 1 *id.* §§ 4.1–4.25.
17. *See generally* 2 *id.* §§ 9.1–9.19.
18. *See generally* 4 J. Pomeroy, A Treatise on Equity Jurisprudence §§ 1235–37 (5th ed. 1941).
19. *See id.* §§ 735-43; 3 G. Palmer, *supra* note 14, § 16.5(c); D. Dobbs, Handbook on the Law of Remedies § 4.7 (1973).

transferring the writings is delivery of possession. Certain aspects of what is often thought to be unique to the holder in due course rules of negotiable instruments law are actually nothing more than natural corollaries of the decision to adopt a possession based system of transfer and title recognition for negotiable instruments.

It is perhaps a universal principle of title recognition systems that once a system has been adopted as the mechanism for establishing interests in a certain type of property, those who have made use of the appropriate title recognition method will be given priority over those whose interests are not properly effectuated. Innumerable instances of the application of this general principle can be found. In the setting of personal property not subject to any special title recognition system, the principal mechanism for the recognition of claims is simply possession. Accordingly, as between a possessory and a non-possessory interest, the possessory interest will often prevail—that, after all, is the essence of *Twynes's Case*[20] and the large body of ostensible ownership principles of fraudulent conveyance law derived from *Twynes's Case*.[21] In the setting of real property transfers, the recording system is now the principal mechanism for the recognition of claims, and accordingly a recorded interest has priority over an unrecorded interest.[22] In the setting of security interests in personal property, perfection, ordinarily by filing, is the appropriate mechanism for the recognition of interests.[23] Thus a perfected interest has priority over an unperfected interest.[24] Indeed, the venerable maxim that legal interests prevail over equitable interests[25] is often simply an instance of this same general principle. This is particularly evident in those instances in which the equitable interest in question is merely an interest that was not effected in the ordinarily proper fashion but would nonetheless be enforced by a court of equity as against the original transferor.[26]

The concept of bona fide purchase is best viewed merely as a derivative aspect of the rules establishing specific mechanisms for the effectuation of interests in property. In most title recognition systems, the class of persons protected by the requirement that interests be recorded, filed, possessory or whatever, is limited to bona fide purchasers. Thus, a mere donee, or person with knowledge or notice of a prior interest, may be precluded from taking advantage of defects in the effectuation of the prior interest. Indeed, it is a bit misleading to say that someone is a bona fide purchaser and *therefore* takes free of a prior claim. Qualifying as a bona fide purchaser may be a necessary condition for invocation of a rule cutting off prior claims, but the basis of such rules is usually that the prior interest was itself not properly effectuated.[27]

20. 3 Coke 80b, 76 Eng. Rep. 809 (1601).

21. *See generally* 1 G. Glenn, Fraudulent Conveyances and Preferences §§ 341–73 (rev. ed. 1970).

22. *See generally* 4 American Law of Property §§ 17.4–17.36 (1952 and Supp. 1977).

23. To emphasize the point that the concept of perfection is essentially a matter of following the appropriate system for recognition of security transfers, Homer Kripke once suggested that the word "perfection" be replaced with a phrase such as "giving (or excusing) public notice." Coogan, *Article 9—An Agenda for the Next Decade*, 87 Yale L.J. 1012, 1032 n.75 (1978).

24. Moreover, for some types of collateral for which either filing or possession is a permissible method of perfection, possession is deemed to be the more appropriate method. Hence a possessory interest has priority over a filed interest. *See* U.C.C. §§ 9–308 and 9–309.

25. *See* 2 J. Pomeroy, *supra* note 18, §§ 416–17.

26. *See* 3 *id.* § 767.

27. *See id.* §§ 735–43.

To return to the concept of negotiability, the adoption of a title recognition system for abstract rights to payment that makes use of the idea of reification of the interests into pieces of paper carries with it certain implications for disputes among competing claims. Specifically, given the notion that the appropriate mechanism for dealing with abstract rights to payment embodied in written instruments is by dealing with the writings themselves, it is natural to hold that a bona fide purchaser who effectuated his or her interest by dealing with the writing will prevail over one who has sought to effectuate an interest by some other method of dealing with the abstract right.[28] Similarly, once it is decided that the appropriate mechanism for dealing with the writing is by taking possession, then it is natural to hold that a bona fide purchaser who established a claim to the instrument by the appropriate mechanism of taking possession will prevail over another party who seeks to establish a claim to the instrument by some other method. Thus, we should expect that a bona fide purchaser who takes possession of a negotiable instrument would be given priority over non-possessory interests in the instrument.

Indeed, the equity bona fide purchase rules, discussed above, that protect purchasers of property against secret equities are, in a sense, but one aspect of the general principle that one whose claim was not properly effectuated risks losing it to one whose claim was properly effectuated. The rescission claims of the sort cut off by the equity bona fide purchase doctrine are those of claimants who did voluntarily transfer the property to the scalawag and later, having discovered facts that cause them to regret the transfers, seek to undo them. In such cases, the claimant's interest will not have been properly effectuated under the applicable title recognition system, for the whole point of the claim is to undo some voluntary transfer that was otherwise properly effectuated. Similarly, most claims of equitable liens are, by definition, claims of interests not properly effectuated under the applicable title recognition system.

Thus, to the extent that the holder in due course rules of negotiable instruments law ensure simply that a party who established a claim to the instrument by the appropriate mechanism of taking possession has priority over another party who seeks to establish a claim by some other method, the protections afforded to holders in due course are not the result of anything special about the holder in due course rules themselves. Rather, they are consequences of the decision to adopt a possession based title system together with the most ordinary of bona fide purchase notions. Accordingly, a major part of the assessment of the negotiability system of title recognition turns on whether possession is a useful basis for the establishment of a system of title recognition for the abstract rights to payment embodied in negotiable instruments.

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28. One can find instances of this aspect of the negotiability technique in the rule that a debt cannot be reached by garnishment or trustee process or the like if it has been embodied in a negotiable instrument; rather, the creditor must attach or levy on the instrument itself. S. Riesenfeld, Cases and Materials on Creditors' Remedies and Debtors' Protection 173 n.2 (3d ed. 1979). *See also* U.C.C. § 8–317(1)(same rule for investment securities).

The appropriate result is less clear in circumstances in which one party acquired an interest in an abstract right by an appropriate mechanism before the abstract right became embodied in a writing and thereafter another party acquired a possessory interest in the writing. The classic discussion of such problems is in Professor Clark's article, *supra* note 12.

Perhaps the central advantage of the possession based title recognition system of negotiable instruments law is that, so long as the concept of possession is taken relatively literally, two people cannot easily have possession of the same instrument at once. Accordingly, from the perspective of one who seeks to protect his or her interest in a negotiable instrument against the possibility that subsequent competing interests may arise, the rule that interests in negotiable instruments can be effectuated only by possession of the instrument provides a simple mechanism of title assurance. By taking and retaining possession of the instrument, the claimant can ensure that no one else can acquire an effective interest in it.

This virtue of the possession system, however, is at the same time one of its principal vices. In many situations it is desirable for several parties to have effective interests in the same item of property, so long as their relative ranking is settled. A prime example is that of consensual security interests.[29] Under the rules of Article 9, it is a simple practice for an owner of property to grant several perfected security interests in most forms of property.[30] Generally, Article 9 rules easily resolve questions of priority among such security interests.[31] The exception, of course, is the case of negotiable instruments. Under Article 9, a security interest in an instrument[32] generally can be perfected only by the secured party taking possession of the instrument.[33] Once one secured party has taken possession of the instrument to perfect the security interest no other secured party can, in the literal sense of the word, take possession, and hence cannot even perfect the security interest so that it would be enforceable even against general creditors or the debtor's trustee in bankruptcy.[34] Since it is unthinkable that the drafters of Article 9 meant to exclude any possibility of junior perfected security interests in instruments, it is clear that under some circumstances the possession of one secured party should suffice to perfect other security interests as well as his or her own. So long as the secured party in actual possession explicitly agrees to act as agent for other secured parties as well as for him or herself, there should be little problem with the perfection of the junior security interests.[35] Even in that case, however, it is far from clear what happens if the secured party in possession, deliberately or by oversight, returns the instrument

29. For discussion of the difficulties with possession as a method of perfection for security interests in general and in negotiable instruments in particular, see Coogan, *supra* note 23; Phillips, *Flawed Perfection: From Possession to Filing Under Article 9* (pts. 1 & 2), 59 B.U. L. Rev. 1, 209 (1979).

30. Section 9–311 explicitly provides that the debtor can transfer an interest in collateral notwithstanding proscriptions against transfers in a security agreement.

31. U.C.C. § 9–312.

32. The term "instrument" in Article 9 includes Article 3 negotiable instruments and Article 8 investment securities. U.C.C. § 9–105(1)(i).

33. U.C.C. § 9–304(1). The only possible non-possessory perfected security interests in negotiable instruments are the temporarily perfected interests permissible under § 9–304(4)(21 day temporary automatic perfection for security interests given for new value under written security agreements), § 9–304(5)(21 day temporary perfection for returns of collateral to debtor for limited purposes), and § 9–306(3)(10 day automatic perfection for instruments as proceeds of collateral subject to filed security interest).

34. Under § 9–301(1)(b) an unperfected security interest is subordinate to the rights of a lien creditor. Under § 544(a) of the Bankruptcy Code, 11 U.S.C. § 544(a) (1982), the trustee in bankruptcy has the rights of a lien creditor under state law.

35. A comment to § 9–305 states that "[p]ossession [for purposes of perfection] may be by the secured party himself or by an agent on his behalf; it is of course clear, however, that the debtor or a person controlled by him cannot qualify as such an agent for the secured party." U.C.C. § 9–305, Comment 2.

to the debtor while the other security interests are still outstanding.[36] Moreover, in cases where the secured party in actual possession declines to cooperate, few lawyers would feel confident giving advice that a perfected junior security interest can be created and maintained.[37]

A further illustration of the inutility of the possession based title recognition system in circumstances where it is desired to effect multiple interests in rights represented by instruments is provided by the development in the past decade or so of an active secondary market for mortgages.[38] Individual notes backed by real estate mortgages have, of course, long been traded to some extent. However, the mechanism of transferring individual debt instruments to individual investors is poorly suited to the development of a modern, large scale financial market, if only because it provides no means for matching the differing desires of mortgage borrowers and investors as to principal, repayment, and maturity terms. Accordingly, here, as in other areas of the capital markets, financial intermediaries operate to channel investors' funds toward borrowers and to enable both borrowers and investors to be accommodated on the terms that they desire, even though those terms may well differ.[39] Secondary mortgage securities of the sort developed in the past few decades seek to combine the advantages of financial intermediation, such as convenient packaging of denominations and maturities, and elimination of the need for the investor to service the individual mortgages, with the advantages of a more direct form of lending, with the ultimate investor as the beneficiary of a claim against the security offered by the ultimate borrower. The mechanism, however, is *not* that assumed by traditional negotiable instruments law—the physical transfer to the ultimate investor of the piece of paper representing the ultimate borrower's promise to pay and security for that promise. Rather, the ultimate investor wishes to take, if anything, only a piece of paper representing his or her interest in the pool of mortgages.[40] Thus, the initial lender, or some other financial entity acting as the packager, will retain the individual notes and mortgages, doing so as representative for the ultimate investors.[41]

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36. *See* Coogan, *Security Interests in Investment Securities Under Revised Article 8 of the Uniform Commercial Code*, 92 HARV. L. REV. 1013, 1028–34(1979)(discussing problem in context of 1977 amendments to Article 8).

37. *See* Haydock, *When is a Broker a Bailee or Is an Interest in Securities a General Intangible?*, 35 ARK. L. REV. 10, 15–17 (1981).

38. Although someone purchasing a mortgage or an interest in a mortgage is acquiring a real estate interest as security for his right to payment, given the principle that the security follows the debt, the mechanism for transferring rights in the note and mortgage securing it is the transfer mechanism applicable to the note. *See* Krasnowiecki, Miller & Ziff, *The Kennedy Mortgage Co. Bankruptcy Case: New Light Shed on the Position of Mortgage Warehousing Banks*, 56 AM. BANKR. L.J. 325 (1982).

39. *See generally* H. KROOSS & M. BLYN, A HISTORY OF FINANCIAL INTERMEDIARIES 3–9 (1971).

40. Modern secondary market mortgage securities take two forms: mortgage-backed bonds, in which the securities are general obligations of the issuer, collateralized by the underlying mortgages, and pass-through securities, in which the securities represent fractional ownership interests in the pool of underlying mortgages. *See* Marcis, *The Conventional Pass-Through Security: A Star Is Born*, 9 REAL EST. REV., Summer 1979, at 59, 60–61. For an overview of the structure of the secondary mortgage market and the role of the federal government and its agencies in the development and flourishing of the market, see J. GUTTENTAG, MORTGAGE PASSTHROUGHS: STRUCTURE AND POLICY: *Hearings Before the Subcomm. on Housing and Urban Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 358 (1983).

41. For example, the Government National Mortgage Association, a principal issuer of secondary market mortgage securities, requires that the original mortgage notes, indorsed in blank, be delivered to a federal or state regulated financial

Several points should be noted about such transactions from the standpoint of negotiable instruments law. It is far from clear that the ultimate investors can be considered holders in due course of the individual mortgage notes that have been packaged into the secondary market security. The investors are certainly not in any literal sense in "possession" of the mortgage notes, and possession, of course, is the essential feature of the negotiability system. No doubt a talented lawyer could devise an argument to the effect that whoever does in fact have possession, in the literal sense, holds the mortgage notes as representative of the secondary market security investors and that they can be considered holders because of the representative's possession. The significant point, though, is that even if such an argument would succeed, it is not a demonstration of the utility of negotiability as a system of title recognition in transactions of this sort, but precisely the opposite. The ultimate investors are *not* relying on their possession of pieces of paper as a means of assuring themselves that they have good claims to the underlying debt claims and mortgages securing them; instead they are relying on the books of the financial intermediaries who packaged the mortgage backed securities, on the honesty and integrity of those financial intermediaries, and the skill and care of the lawyers and other professionals who are paid to ensure that the procedures are handled properly. In short, the possession based negotiability title recognition system has essentially been abandoned; the procedures and records of the financial intermediaries provide the real title recognition system for interests in mortgage notes traded in the secondary market.

Even in circumstances in which it is not intended that there be several interests in the same instrument, the possession based system of negotiable instruments law is quite ill-suited to high volumes of transactions. The problem was strikingly illustrated by the so-called "paper crunch" in the stock markets in the 1960s, when it became simply impossible to push around the pieces of paper fast enough to keep pace with the volume of trading.[42] The response to the problem is quite revealing. Article 8 was amended by the addition of Section 8–320 which provides a mechanism for effecting transfers of interests in investment securities by book entries rather than transfer of possession.[43] Under Section 8–320, securities can be deposited with clearing corporations and transfers of interests in the securities are effected simply by appropriate entries on the books of the clearing corporation.[44] For the great bulk of trading of securities on the major stock exchanges, the Section 8–320 central depository book entry system has largely displaced the traditional mechanism of transferring specific certificates.[45] A major portion of the outstanding shares of a given issue of securities may be represented only by one or two jumbo certificates held for clearing

institution to be held pursuant to a custodial agreement. GOVERNMENT NATIONAL MORTGAGE ASS'N, REGISTRATION DOCUMENTS, ch. 8, *reprinted in* 1 REAL ESTATE SECURITIES REGULATION SOURCEBOOK 1151, 1164 (S. Roulac, ed. 1975).

42. *See generally* Guttman, *Toward the Uncertificated Security: A Congressional Lead for the States to Follow*, 37 WASH & LEE L. REV. 717, 717–19 (1980).

43. Section 8–320 was added in the 1962 Official Text of the Uniform Commercial Code.

44. For discussions of the operation of the central depository book entry system, see Potter & McLean, *Introduction to Book Entry Transfer of Securities*, 28 BUS. LAW. 209 (1972); Gillette & Maher, *Revised Article 8: Issuers Beware!*, 15 U.C.C. L.J. 146, 152–54 (1982); Guttman, *supra* note 42.

45. *See* Gillette & Maher, *supra* note 44, at 152–54; Potter & McLean, *supra* note 44, at 212.

corporations,[46] so that all of the actual trades of those securities are effected by book entry. The certificates in such a system have become largely superfluous, and the possession based system of title recognition of negotiable instruments law has effectively been supplanted by a system based on notations on the records of financial institutions.[47] Indeed, even aside from the development of the central depository book entry system, the possession based title recognition system had in large measure been abandoned for investment securities inasmuch as many purchasers of securities allow them to be registered in street name with their broker rather than demanding actual issuance of certificates in their name.[48] One who owns securities registered in street name is, of course, relying for assurance of title not on the possession of certificates but on the integrity of the records of the stockbroker.[49]

It is apparent, then, that the reliance of the negotiability system of title recognition on the concept of possession renders the system increasingly ill-suited to the demands of modern commercial transactions. The inutility of the possession based system, however, is not limited to sophisticated modern forms of securities transfer. Rather, even in simple, garden variety transactions involving rights that are embodied in instruments, the extreme importance that the negotiability system places on possession of the writing produces a rather ironic result. The breezy explanations of the virtues of the concept of negotiability that are generally found in judicial opinions and the introductory passages of books on negotiable instruments law almost invariably assert that the purpose of the negotiability rules is to protect bona fide purchasers of negotiable instruments by conferring on them the exalted status of holder in due course. It seems likely, however, that the principal effect of the rule that no effective interest in a negotiable instrument can be effected other than by possession is that those who have acquired effective interests must see to it that no one else gets possession of the instrument.[50] The point then is not so much to be sure that you are a holder in due course as to ensure that no one else becomes one!

The observation that preventing others from acquiring holder in due course status may be as or more significant than acquiring it oneself is not simply an amusing

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46. *See* Haydock, *supra* note 37, at 13–14.

47. In recognition of the diminished significance of stock certificates, the Permanent Editorial Board for the Uniform Commercial Code has promulgated a revised version of Article 8 providing for uncertificated securities. *See* American Law Institute & National Conference of Commissioners of Uniform State Laws, Uniform Commercial Code: 1978 Official Text with Comments 779 (Reporters Introductory Comment) [hereinafter U.C.C. (1978)]. As of July 1985, the 1977 amendments had been adopted in only fourteen jurisdictions. 6 W. Willier, F. Hart & R. Desiderio, U.C.C. Rep. Dig. (Bender) 1–636.665 (1985). There is some dispute about the need for revised Article 8, *see* Gillette & Maher, *supra* note 44, at 147–48, and considerable dispute about the wisdom of the approach taken in the 1977 amendments, particularly the decision to replicate to the greatest extent possible the existing rules for certificated securities, *compare* Coogan, *supra* note 36 *with* Aronstein, Haydock & Scott, *Article 8 is Ready*, 93 Harv. L. Rev. 889 (1980).

48. *See* Securities and Exchange Comm'n, Final Report of the Securities and Exchange Comm'n on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of Such Securities 79 (1976)(in 1975 nearly 30% of publicly held equity securities were registered in nominee and street name).

49. The customer is protected against loss by failure of the brokerage under the Securities Investor Protection Act, 15 U.S.C. § 78aaa-lll (1982). *See generally* Sowards & Mofsky, *The Securities Investor Protection Act of 1970*, 26 Bus. Law. 1271 (1971).

50. That is certainly the only role of possession of the instrument in systems such as the issuance of mortgage backed securities.

sidelight. Rather, the effect of the rule that possession is required to obtain an effective interest in negotiable instruments—particularly when coupled with the further rule that even one who did establish an interest in an instrument by the appropriate means of taking possession risks losing that interest if someone else gets possession—is that one who owns or has some other interest in a negotiable instrument must exercise extraordinary care in safeguarding the physical piece of paper. The need for careful safekeeping of the writings can, at the least, be troublesome. Checks or notes must be carefully guarded. Investment securities are often stored in safe deposit boxes or otherwise left with banks or brokerages for safekeeping. Moreover, the need for careful safekeeping may have the effect of thwarting whatever other advantages a possession based system may offer. For example, an assumption of any possession based system of title recognition is that possession or the lack thereof will provide a useful means for learning of the potential existence of interests in property. In the case of negotiable instruments, however, the likelihood that one representing him or herself as the owner of negotiable instruments, which have in fact been transferred to another, will succeed in the fraud is all the greater by virtue of the fact that that individual has such a plausible excuse for failing to exhibit the instruments: "Oh, they're in my safe deposit box, or with my broker, and I can't get at them just now."[51] Moreover, one putative advantage of a possession based system of title recognition is that it facilitates rapid and simple transfers. If, however, the instruments must be squirreled away for safekeeping, then when the time comes to transfer them they will have to be retrieved, often a not insignificant nuisance.

IV. Negotiabiltiy and the Rule of Last in Time, First in Right

In the previous section of this Article the utility of the negotiability title recognition system was considered by focusing on those aspects of the negotiability system that rest on the requirement that one take possession of a negotiable instrument in order to obtain an effective interest in it. To the extent that possession has proved to be a poor basis on which to erect a system of title recognition, the case for the negotiability system of title recognition is greatly weakened, for, as has been noted above, most of what are often thought to be special attributes of negotiable instruments law are actually only consequences of the decision to adopt a possession based title recognition system, together with the most ordinary of bona fide purchase concepts. This section of the Article considers the one aspect of the holder in due course rules that is genuinely unique to the negotiability system of title recognition—the rule captured in the saying that only in the case of negotiable instruments can one derive good title through a thief. Again, the method of analysis will be to consider the extent to which this aspect of the negotiability system actually comes into play in modern transactions and the disadvantages of adherence to the rule.

51. *See generally* Coogan, *supra* note 23, at 1033–36 (questioning whether possession serves public notice function of perfection); Phillips (pt. 1), *supra* note 29, at 34–41 (same).

Although this is not generally noticed, the rule that a holder in due course of a negotiable instrument takes free from all adverse claims actually combines two quite different concepts:

1. one who established a claim to the instrument by the appropriate mechanism of taking possession has priority over another who seeks to establish a claim by some other method; and,
2. one who has possession of the instrument has priority even over a prior party who did establish a claim to the instrument by the appropriate mechanism of taking possession, but later lost possession through some wrongdoer's action.

As has been shown above, the first of these two concepts is simply an application of general principles of title recognition systems to the possession based system of negotiable instruments law. The second of these two concepts, however, is unique to negotiable instruments law.

This aspect of negotiability doctrine is indeed quite an extraordinary rule, because the priority afforded to the later in time interest is not contingent on any defect in the effectuation of the earlier in time interest. Accordingly, this aspect of the holder in due course rules essentially amounts to the adoption of a last in time, first in right rule for conflicts among equally worthy claims. That, of course, is contrary to the most general rule of property transfer systems. In virtually all other title recognition systems, one who has properly effectuated an interest will not lose the right to a later party who was the innocent victim of some scalawag's wrongdoing.[52] For example, one who loses goods by simple theft can recover them from a bona fide purchaser no matter how commercially significant or ordinary the transaction in which the purchaser acquired the goods.[53] Similarly, if a secured party makes a proper filing, but the filing is not properly recorded and indexed, whether by simple error in the filing office or by some form of skullduggery, the secured party would not lose the priority to a subsequent secured party who took a security interest in reliance on the apparent state of the records and properly filed the interest.[54]

Ordinarily, this special rule for negotiable instruments is justified by fairly breezy suggestions to the effect that, were this not the rule, negotiable instruments would not in practice be freely transferable. In order to assess the soundness of this distinguishing feature of the negotiability system of title recognition, we should

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52. Pomeroy makes this point quite emphatically, chiding those who have overgeneralized bona fide purchase concepts into a purported universal rule protecting any subsequent bona fide purchaser:

> When the original legal owner has done or omitted something by which it was made possible that his property should come into the hands of a *bona fide* holder by an apparently valid title, it may be just to regard him as estopped from asserting his ownership, and thus to protect the subsequent purchaser. But when the proper legal owner is wholly innocent, and has done and omitted nothing, it certainly transcends, even if it does not violate, the principles of equity to sustain the claims of a subsequent and even *bona fide* purchaser.

3 POMEROY, *supra* note 18, § 735.

53. For example, one who purchases goods from an ordinary retail merchant could well take subject to another's claim of ownership if the goods had been stolen and then found their way back into ordinary channels of distribution. One such example, very much in the news a few years ago, is a truck hijacking situation. Moreover, the rule that a bona fide purchaser can derive no title through a thief is applied even in the setting of goods which are frequently traded and extraordinarily valuable, such as art objects, precious stones, and the like.

54. Section 9–403(1) provides that "*Presentation* for filing of a financing statement . . . constitutes filing under this Article." (emphasis added).

consider the extent to which the negotiability system really does provide assurance of good title, the extent to which that assurance would not be provided by other title recognition systems, and any adverse consequences of the negotiability system of title recognition.

In assessing the utility of this aspect of the negotiability system of title recognition it will be useful to concentrate primarily on ownership claims.[55] The simplest sort of such claim is that of one who lost a negotiable instrument through outright theft. Similar, but somewhat more complex, are claims that an instrument was transferred by one purporting to act on behalf of the actual owner who did not in fact have authority to do so, or who acted in excess of actual authority. It is easy to imagine circumstances in which the existence or possibility of such claims could prove troublesome to a remote transferee. One should not, however, fall into the trap of believing that negotiability concepts protect purchasers of negotiable instruments from such uncertainties. The fact is that in most circumstances the holder in due course concept is of absolutely no assistance to transferees of negotiable instruments facing such claims.

The explanation is quite simple. In order to be a holder in due course, one must first be a holder.[56] Whether a transferee becomes a holder depends on whether the instrument was properly negotiated.[57] Negotiation in turn depends on the form of instrument: if the instrument is in bearer form, it can be negotiated by delivery alone,[58] while if the instrument is in order form it can be negotiated only by delivery along with a proper, authorized indorsement.[59] In the case of bearer paper, then, it is quite easy for a transferee to become a holder, and hence the holder in due course rules would enable a transferee of bearer paper to cut off ownership claims of prior parties who lost the instrument by theft or action by an agent in excess of authority. In the case of instruments in order form, however, the same circumstances that give rise to the claim of ownership will ordinarily prevent subsequent transferees from becoming holders. In the simple case of theft, where the instrument is payable to the order of the person from whom the instrument is stolen, the true owner will be able to recover the instrument from any subsequent bona fide purchaser, or will have an action for conversion against any such purchaser, since the thief will have had to forge the true owner's indorsement in order to pass the instrument along. That forgery will prevent any subsequent purchaser from becoming a holder. Similarly if an owner loses an order instrument through action of the owner's agent in excess of authority, the owner will ordinarily be able to recover the instrument from any subsequent bona

55. Since disputes about other forms of claims often turn largely on other considerations, disputes concerning conflicting ownership claims provide the purest basis for testing the conventional wisdom about this aspect of negotiability doctrine. By contrast, in the case of adverse claims of the sort herein called secret equities, it is not negotiability but general bona fide purchase concepts that provide title assurance. *See supra* text accompanying notes 14–19. Similarly, the problems posed by the negotiability doctrine in the system for recognition of consensual security interests are in large measure general difficulties about the use of possession as a mechanism of perfection of security interests. *See supra* text accompanying notes 29–37.

56. U.C.C. § 3–302(1) ("A holder in due course is a *holder* who takes the instrument. . . . ") (emphasis added).

57. U.C.C. §§ 3–202(1), 1–201(20).

58. U.C.C. § 3–202(1).

59. *Id.*

fide purchaser, or will have an action for conversion against any such purchaser, for the owner's agent will have had to indorse the instrument, purporting to do so on behalf of the principal, and if that indorsement is held to have been ineffective,[60] then no subsequent purchasers will qualify as holders.

Whether an agent's indorsement is effective depends essentially on the law of agency, not any special rules of negotiability. Section 1–201(43) provides that "'[u]nauthorized' signature or indorsement means one made without actual, implied, or apparent authority and includes a forgery."[61] Thus, the position of a transferee of a negotiable instrument in order form that was transferred by an agent in excess of the agent's actual authority is at best the same as that of a transferee of any other form of property in such circumstances. Indeed, it is likely that the position of a transferee of a negotiable instrument in these circumstances is *less* secure than that of a transferee of any other form of property, for the judicial decisions evidence a tendency to construe quite narrowly the authority of an agent to indorse negotiable paper on behalf of the agent's principal. The decisions often begin from the premise that in view of the importance of negotiable instruments to the principal's business, authority to indorse on behalf of the principal will not be "lightly inferred,"[62] and there are many instances in which agents have been held to lack authority to indorse negotiable instruments in circumstances where it seems likely that the agents would have been held to have implied authority to transfer other forms of property. For example, in *Aetna Casualty and Surety Co. v. Hepler State Bank*,[63] a commission salesman for a feed company who had received checks from customers payable to the company indorsed them in the name of the company and appropriated the proceeds to his own use. The depositary bank that collected the checks for the salesman was held liable to the company for conversion on the basis of the fairly settled proposition

60. U.C.C. § 3–404(1) provides that "[a]ny unauthorized signature is wholly inoperative as that of the person whose name is signed . . . ." Comment 1 to that section explains that the term unauthorized signature "includes both a forgery and a signature made by an agent exceeding his actual or apparent authority."

61. *See, e.g.*, Hartford Accident & Indem. Co. v. South Windsor Bank & Trust Co., 171 Conn. 63, 368 A.2d 76 (1976)(relying on general agency law for proposition that insurance agent lacked implied authority to indorse premium check made payable to insurer and received by agent).

62. *E.g.*, Coleman v. Seattle Nat'l Bank, 109 Wash. 80, 89, 186 P. 275, 276 (1919), *quoting* 1 F. MECHEM, A TREATISE ON THE LAW OF AGENCY § 969 (2d ed. 1914)("The power to bind the principal by the making, accepting, or indorsing of negotiable paper is an important one, not lightly to be inferred. . . . Our law therefore properly regards such an authority as extraordinary, and not ordinarily to be included within the terms of general grants.").

Indeed, the field of negotiable instruments law has provided what may be the most extreme instance of narrow construction of an agent's authority known to American law. Although section 19 of the N.I.L. provided that "[t]he signature of any party may be made by a duly authorized agent . . . [and] the authority of an agent may be established as in other cases of agency . . . ," several states adopted non-uniform versions providing that "[t]he signature of any party may be made by an agent duly authorized in writing. No particular form of written appointment is necessary for this purpose." T. GREEN, PRACTICAL SUMMARY OF NEGOTIABLE INSTRUMENTS 158 (1938); J. OGDEN, THE LAW OF NEGOTIABLE INSTRUMENTS § 148, at 256 (5th ed. 1947). Under such a provision, it was held in State Bank of Alcester v. Weeks, 45 S.D. 639, 189 N.W. 941, *on rehearing*, 46 S.D. 93, 190 N.W. 806 (1922), that a bank which had purchased a promissory note from one who purported to act as agent for the payee corporation was not a holder in due course. A letter written by the treasurer of the payee corporation to the bank stating that the agent did have authority was held insufficient on the grounds that it was merely "an unsworn statement . . . that [the agent] had such authority" rather than itself conferring such authority. Nor was the bank's position improved by the fact that the payee did not in fact dispute that the agent had authority and had accepted the proceeds of the bank's purchase of the note such as would otherwise amount to a ratification. *See also* Finley v. Smith, 165 Ky. 445, 177 S.W. 262 (1915)(similar interpretation of similar Kentucky version of N.I.L.).

63. 6 Kan. App. 2d 543, 630 P.2d 721 (1981).

that neither authority to sell goods for the principal nor authority to make collections gives implied authority to indorse checks received in payment.[64] If the salesman had accepted other grains from a customer in payment of a debt to his principal and then, without actual authority, transferred the grains received in payment to another, it seems virtually certain that the court would have used implied authority concepts to protect the purchaser of the goods from a conversion action brought by the principal.

Similarly, in *Confederate Welding and Safety Supply Inc. v. Bank of the Mid-South*,[65] a depositary bank was held liable for conversion where it had permitted one who was president, one-half owner, office manager, and bookkeeper of a corporation to indorse a check payable to the corporation and deposit it in his personal account. The court observed that "[i]t is well-established that the mere fact that an employee has managerial status and is in charge of a company's office does not entitle third persons to assume that he had the authority to execute or endorse negotiable paper belonging to his employer."[66] Again, it seems quite likely that one who acquired some other form of property from someone having such general managerial responsibilities would have been protected by implied authority doctrines.

Thus, the lawyers' cliches about how negotiability and the holder in due course doctrine are essential to ensure the security of title of transferees of negotiable instruments are, at best, a gross exaggeration: a bona fide purchaser of a negotiable instrument takes free from prior ownership claims only if the instrument was in bearer form at the time that the questionable transaction occurred. If the instrument was in order form at that time, the effect of the rules of transfer for negotiable instruments law is precisely the opposite of that assumed by the usual assertions: the negotiability rules ensure that any subsequent parties, even bona fide purchasers, will take subject to the prior ownership claim.

Thus, the assessment of the suggestion that negotiability is essential to modern commercial transactions because it facilitates the free transferability of debt claims depends, to some degree, on the extent to which debt claims are transferred in bearer form rather than order form. A full examination of that question would be beyond the scope of this Article, but it is hardly the case—as one who believes the ordinary propaganda of negotiability should conclude—that transactions involving transfer of instruments in order form are significantly less common, because far riskier, than transactions involving transfers of instruments in bearer form.

Consider, for example, the matter of the markets for investment securities such as stocks and bonds. Although investment securities are governed by Article 8 rather than Article 3, Article 8 largely replicates the rules of Article 3 concerning transfer and the rights of transferees. Thus, the rights of a transferee of investment securities differ significantly depending on whether the security is in bearer form or registered form. A transferee of a security in bearer form can qualify as a "bona fide purchaser" who takes free of adverse claims simply by taking possession of the security.[67] On the

64. *Id.* at 548–49, 630 P.2d 721, 726–27, *citing* H. BAILEY, BRADY ON BANK CHECKS § 23.17 (5th ed. 1979).

65. 458 So. 2d 1370 (La. App. 1984).

66. *Id.* at 1375.

67. The term "bona fide purchaser" is used in a specific defined sense in Article 8. Section 8–302 provides that

other hand, if a security is in registered form,[68] a transferee cannot become a "bona fide purchaser" unless the security is "indorsed" to the transferee by a person actually authorized to do so.[69] Accordingly, one who is, in the colloquial sense, a bona fide purchaser of a security in registered form bearing a forged indorsement is disqualified by the specific Article 8 transfer rules from attaining the status of "bona fide purchaser" in the special defined sense in which that term is used in Article 8. Hence, this "bona fide purchaser" takes subject to the claim of the true owner whose indorsement was placed on the security without authority. Thus, standing alone, the negotiability concept as adopted in Article 8 does not provide the transferee of a security in registered form with protection against adverse claims.[70] It would, though, require an impressive feat of blindness to reality to suppose that registered securities are not freely transferable because of the legally uncertain position of a bona fide purchaser who takes under an unauthorized indorsement or stock power. Indeed, equity securities are almost invariably issued in registered form,[71] if only because of the issuer's need to maintain shareholder lists for purposes of dividend distributions, voting, and the like.

The explanation of this seeming anomaly is that the negotiability system is not really used as the system of title recognition for corporate stock or other securities issued in registered form. The key to the title recognition system for registered securities is not possession of the certificate, as in the negotiability system of title recognition, but registration of ownership on the books of the issuer. The purchaser of a security obtains assurance of title, and freedom from adverse claims of prior owners, not by taking possession of the certificate, but by registration of the transfer to the purchaser on the books of the issuer. Section 8–311 provides that a "purchaser for value and without notice of adverse claims who has in good faith *received a new, reissued or re-registered security on registration of transfer*," takes free from the claim of a prior owner that the security was transferred through an unauthorized indorsement or stock power.[72] Thus, in the setting which is perhaps the preeminent

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"[a] 'bona fide purchaser' is a purchaser for value in good faith and without notice of any adverse claim who takes delivery of a security in bearer form or of one in registered form issued to him or indorsed to him or in blank."

68. U.C.C. § 8–102(1)(c) provides that "a security is in 'registered form' when it specifies a person entitled to the security or the rights it represents; and when its transfer may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security so states."

69. U.C.C. §§ 8–302 and 8–308. Section 8–308(1) provides that indorsement may be effected on the certificate itself or on a separate document, such as the typical "stock power." U.C.C. § 8–308(3) resolves a number of agency questions concerning indorsement authority in problematic situations such as the death or incapacity of the person otherwise authorized to indorse. However, nothing in § 8–308, the 1977 amendments to that section, or elsewhere in Article 8 alters the basic rule that an unauthorized indorsement is ineffective to confer good title.

70. Section 8–311(a) states explicitly that the owner of a security can assert a claim against a good faith purchaser who took through an unauthorized indorsement unless and until the purchaser avails him or herself of the real mechanism for title assurance—registration of the transfer on the books of the issuer.

71. C. Israels & E. Guttman, *supra* note 6, at 11 ¶ 1.07.

72. U.C.C. § 8–311(a)(emphasis added).

The system of registration of transfer on the records of the issuer not only provides the purchaser with assurance of title, but it also provides a mechanism far superior to the negotiability system of title recognition for protecting the true owner's rights. Although registration of transfer cuts off the owner's rights against the purchaser, the issuer who registers a transfer on an unauthorized indorsement or stock power is subject to liability to the true owner for improper registration. U.C.C. §§ 8–311(b) and 8–404. Issuers, of course, commonly seek to protect themselves against this liability by such devices as requiring signature guaranties. *See* U.C.C. § 8–402.

example of a market in which abstract claims are frequently transferred and in which there is real need for an adequate system of title assurance, the negotiability system has essentially been abandoned and replaced with a form of recording system.[73]

Even for instruments in bearer form, for which the negotiability system is the operative system of title recognition, it is by no means obvious that negotiability is unambiguously a good thing. There is, for example, no *a priori* reason for believing that negotiability promotes the marketability of instruments. Although a bona fide purchaser of a negotiable instrument in bearer form takes free from all adverse claims, that protection comes at the cost of extreme risk of loss of one's rights to a subsequent bona fide purchaser. The risk of loss, and the consequent necessity for extreme care in safeguarding the securities, that come from negotiability may well make negotiable instruments unattractive to investors.

There is at least some empirical basis for believing this may at times be the case. One category of securities that formerly were generally issued in bearer form is United States government bonds. As a consequence of their negotiable character, United States bonds became particularly attractive targets for theft. In the early 1970s the federal government became concerned that the risks of loss through theft would impair the marketability of government securities.[74] Accordingly, federal regulations were promulgated providing that government securities can be delivered to a Federal Reserve Bank where book entries are made to show the identity of the owner and the

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73. Curiously, though, even those who should be expected to be most familiar with the operation of Article 8 seem not to have noticed that negotiability does not really play a significant role in the transfer sytem for securities. Article 8 itself makes a point of asserting that the securities governed by it "are negotiable instruments," U.C.C. § 8–105(1), and the commentary on Article 8 is replete with the usual assertions about the essentiality of negotiability. A standard treatise on Article 8, for example, asserts that "[s]ince both commercial paper and investment securities are intended to pass from hand to hand in 'market' transactions of one form or another, the instrument must be in the legal sense fully 'negotiable.'" C. Israels & E. Guttman, *supra* note 6, at 3 ¶ 1.03.

When the drafters of the 1977 amendments to Article 8 responded to Peter Coogan's criticisms of their product, they made the same assumption about the significance of negotiability, notwithstanding that they had themselves just finished rewriting the very rules that make negotiability irrelevant. The major thrust of Coogan's criticism of the 1977 amendments was that the effort to replicate for uncertificated securities the possession based system of negotiable instruments law was misguided. *See* Coogan, *supra* note 36, at 1013–16. In the course of that criticism, Coogan noted, *id.* at 1015 n. 8, that the concept of negotiability "is currently under attack in academic circles," citing Rosenthal's well-known article, *Negotiability—Who Needs It?*, 71 Colum. L. Rev. 376 (1971). The drafter's response to Rosenthal's question was that negotiability was essential for investment securities because

> [s]ecurities . . . are the subject of regular trading between parties unknown to each other, typically through the auspices of brokers and other intermediaries. Each party in the sale transaction looks to the preceding party in the chain to convey a property interest free of claims and defenses. If there is any single quality that uncertificated securities must have if they are successfully to displace certificates, it is negotiability.
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> . . . .
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> Revised article 8 extends the concept of bona fide purchaser to the uncertificated security and identifies the means by which one may attain that hallowed status. Without such protection, would any right-minded person buy and pay for an uncertificated security from an unknown seller? . . . One answer to Professor Rosenthal's provocative question, "Negotiability—who needs it?" is: just about everybody who deals in securities.

Aronstein, Haydock & Scott, *supra* note 47, at 895–96 (footnotes omitted).

This comment is a prime example of the failure to distinguish between the need for some effective system of title recognition and the desirability of the particular features of the negotiability system of title recognition. Of course there is a need for a system to provide assurance of title to purchasers of investment securities. Negotiability, however, simply is not such a system and is in fact not even used for certificated securities.

74. *See* Coogan, *supra* note 23, at 1037–38 (1978).

bonds themselves are destroyed.[75] Subsequent transfers can be made by notation on the records of the Federal Reserve Bank.[76] Over ninety-five percent of Treasury securities are now in book entry form.[77]

The development of the federal book entry system points to another adverse effect of the negotiability system: the absence of any record of ownership or transfer of negotiable instruments may facilitate illicit transactions. Instruments such as currency and bearer bonds are not only attractive targets for theft, but also are unfortunately well-suited as a medium of exchange and investment for those engaged in criminal transactions or those who wish to evade reporting requirements such as those imposed by the tax laws.[78] Indeed, prompted by such concerns,[79] Congress in 1982 effectively prohibited the issuance of long term securities in bearer form by denying the income tax deduction for interest paid by the issuer on most securities having a maturity of more than one year unless the securities are issued in registered form.[80]

To summarize, the basic assumptions of negotiable instruments law, that purchasers of negotiable instruments are given extraordinary protections and that this protection is essential to commercial transactions, are wildly inaccurate. In many circumstances, a bona fide purchaser of a negotiable instrument receives the same, or less, protection against adverse claims than a bona fide purchaser of other forms of property. Even in those circumstances in which the negotiability rules do confer extraordinary protections on bona fide purchasers of negotiable instruments, it is far from clear that this is a good thing. There is, after all, nothing affirmatively desirable about cutting off ownership claims. The goal of a system of title recognition should be to provide assurance of title to purchasers by enabling them to discover the existence of adverse claims before purchasing the property, rather than by simply obliterating all prior legitimate ownership claims. Compared to recording or filing systems, the negotiability system of title recognition is extremely crude, and its use is justifiable only if the nature of the transactions in question are such that no better title recognition mechanism is feasible. Time after time, as the deficiencies of the negotiability system of title recognition become more and more troublesome for particular forms of transactions, essentially the same solution is devised: abandon the

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75. The Department of Treasury regulations on book entry of federal government securities are now found at 31 C.F.R. § 306.115 - .122 (1985).

76. *Id.* For descriptions of the operation of the book entry system for federal government securities, see Coogan, *supra* note 23, at 1037-40.

77. Ringsmuth, *Federal Reserve Book-Entry System and the Role of the Federal Reserve*, in PRACTICING LAW INSTITUTE, REPURCHASE AND REVERSE REPURCHASE AGREEMENTS 1985, at 53.

78. For example, although the risk of loss attendant upon negotiability makes currency sufficiently unattractive as a payment mechanism that it is rarely used in licit large transactions, the absence of any record of cash transactions—which is itself an attribute of the negotiability system of relying exclusively on possession—makes cash the payment medium of choice in all illicit transactions. Indeed, the abolition of currency is from time to time suggested as a crime prevention measure.

79. S. REP. No. 97-494, 97th Cong., 2d Sess. 242-44, *reprinted in* 1982 U. S. CODE CONG. & ADMIN. NEWS 995-98.

80. 26 U.S.C. § 163(f) (1982 & Supp. 1985) (the section remained identical after the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 99th Cong., 2d Sess. (1986)). Similarly, long-term tax exempt municipal securities are now required to be in registered form. 26 U.S.C. § 103(j) (1982) (under the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 99th Cong., 2d Sess. (1986), now § 103(b) is the relevant section, providing that to be tax exempt, long-term municipal securities must be registered pursuant to § 149—renumbered § 103(j)).

negotiability system of title recognition and replace it with some form of recording or filing system. The concept of negotiability, then, is not something to praise as a keystone of commercial law in economically developed societies which is to be jealously guarded and protected. Rather, the concept should be regarded with considerable skepticism and suspicion, for in modern transactions the doctrine of negotiability is more likely to be a fly in the ointment than oil for the wheels of commerce.

V. The Role of Negotiable Instruments in Modern Title Recognition Systems

There are two major aspects of the demonstration in the preceding section that the negotiability system does not in fact operate as is commonly assumed. First, the holder in due course rules operate to cut off prior ownership interests only in the case of instruments in bearer form. Second, the effect of the rules of negotiable instruments law for instruments in order form is to ensure that claims of ownership are preserved rather than cut off. In one sense, there is nothing particularly remarkable about these observations. Indeed, they simply mirror the basic thumbnail summary of the rules on theft of negotiable instruments found in every hornbook and outline: For stolen bearer paper the loss falls on the one who lost it, while for stolen order paper the loss falls on the one who took it from the thief. In another sense, however, the inconsistency between this well-known rule and the usual assumptions about the purpose of negotiability is striking. The introductory passages of works on commercial paper invariably assert that negotiability is one of the most important concepts of commercial law, because it provides a degree of protection against adverse claims without which commercial transactions could not go forward. Several chapters later, however, the same works explain in excruciating detail the rules on negotiation and indorsement which have the effect of ensuring that a purchaser of an instrument in order form takes subject to claims of ownership!

There is a more important moral to be drawn from this anomaly than the observation that lawyers are as subject to cognitive dissonance as others. The usual chestnut of negotiable instruments law, that the outcome of a case of theft of negotiable instruments turns on whether the instrument was in bearer form or order form at the time it was stolen, is deeply misleading. Such a summary of the rules of negotiable instruments law reflects the assumption that the rules on forgery, theft, and the like are all particular aspects of one unitary system of negotiable instruments law. The specific outcomes of the application of the rules of this system are seen as turning on specific facts about the specific fashion in which the parties involved in the particular dispute happened to have dealt with the instrument in question. This view is particularly apparent in the sort of justifications one is likely to find offered for the rules: People who indorse instruments in blank and leave them lying around have been careless and so should bear the loss resulting from their theft, which, after all, could not readily have been detected by one who took the instrument from or through a thief. On the other hand, a person who accepts a stolen order instrument from the thief might have prevented the loss by more careful examination of the indorsement and identification of the person offering the instrument.

A far more accurate understanding of the operation and role of the rules of negotiable instruments law can be attained by thinking of negotiable instruments law not as a unitary system, but as incorporating two separate and wholly different systems of title recognition: one, the system applicable to bearer paper, does in fact provide special protections to purchasers of the instruments, while the other, the system applicable to order paper, has precisely the opposite effect. The choice between the two systems, however, should turn not on specific facts about what the parties in question happened to have done with the instruments, but on the nature of the instrument itself and the sort of transaction in which it is typically used.

As is well known, the rules protecting a holder in due course from adverse claims were developed in cases involving instruments that were commonly circulated from hand to hand as a form of paper currency. For example, *Miller v. Race*,[81] the case establishing the rule that a bona fide purchaser of a negotiable instrument takes free from prior claims, involved a Bank of England note, and *Peacock v. Rhodes*,[82] holding the same rule applicable to a bill of exchange indorsed in blank, involved a bill of exchange that had passed through at least four hands before being used as payment for a purchase of cloth from a mercer's shop. Lord Mansfield's opinions in both cases make it quite clear that the rule cutting off the claims of those who lost the instruments was based on the needs of the system in which such instruments were used as a form of currency. To the extent that negotiable instruments were in fact used as a form of currency, the application of the holder in due course rules applicable to bearer paper makes perfect sense, for they simply mirror the rules applicable to coin.[83]

If, however, the choice between the bearer paper rules and the order paper rules depended on specific facts about what the parties did with the instruments, then one who took an instrument in payment would often not obtain the assurance of good title that the opinions of Lord Mansfield's day considered so important to the use of negotiable instruments as a form of currency. Suppose, for example, that a bank note was issued in bearer form, but at some point in its passage through the hands of many parties one of them converted it to order form by a special indorsement. Even if it appears from the instrument that it was returned to bearer form by the special indorsee's blank indorsement, no taker of the instrument could be assured of obtaining good title; for there would always be the risk that the instrument had been stolen at the time it was in order form. Indeed, to one schooled in the transfer rules of Article 3, the classic case of *Peacock v. Rhodes* should itself seem inexplicable, for the report of the case indicates that the instrument in question was a bill of exchange which seems to have been indorsed at each stage of its transfer. If, as the

81. 1 Burr. 452, 97 Eng. Rep. 398 (K.B. 1758).

82. 2 Dougl. 634, 99 Eng. Rep. 402 (K.B. 1781).

83. Although there can be no dispute that good title to currency can be derived even from a thief, it is, ironically, difficult to find pure authority for this proposition. Even cases that do involve coin, *e.g.*, Chapman v. Cole, 78 Mass. (12 Gray) 141 (1858) and Brown v. Perera, 176 N.Y.S. 215 (App. Div. 1918), seem to rely on *Miller v. Race*.

presence of these indorsements would seem to suggest, the bill had been in order form at the time it was stolen, then the merchant who ultimately took it in payment for goods could not have qualified as a holder and hence would have taken subject to the true owner's claim.

The resolution of this puzzlement lies in a seldom noted aspect of Article 3 of the U.C.C. Under Section 3–204, any special indorsement converts an instrument into order form, even if the instrument was initially issued to bearer. As the comment to this section notes, this was a change in the law, for it was very clear under the common law and the Uniform Negotiable Instruments Law that an instrument initially issued in bearer form remained such an instrument, no matter what sort of indorsement was placed on it.[84] Similarly, Section 3–204(3) of the U.C.C. provides that if an instrument issued in order form has been converted to bearer form by a blank indorsement, it can readily be returned to order form by a special indorsement. That was also the case under the Uniform Negotiable Instruments Law;[85] however, the Uniform Negotiable Instruments Law rule was a change from the common law under which an instrument issued in order form but indorsed in blank became bearer paper and could not thereafter be changed back to order form by a special indorsement.[86] Thus, at common law, the bank note involved in *Miller v. Race* would have been governed by the bearer paper rules regardless of any indorsements that might have been placed on it. So too, once the bill of exchange involved in *Peacock v. Rhodes* had been indorsed in blank by the original holder, no subsequent special indorsement would have been effective to return it to order form. As one of the leading treatises on the Uniform Negotiable Instruments Law puts it, the rule at common law was "once bearer paper, . . . always bearer paper."[87]

Thus, in the era in which negotiable instruments were actually used as a form of currency, the bearer paper system of rules came into play for those instruments used as currency. In addition, the rules of negotiable instruments law ensured that specific actions by parties who dealt with the instruments could not cause that system of rules to be displaced. That, of course, was an eminently sensible system of rules, given the existence of a system of practice in which privately issued instruments actually did serve as currency. Application of the rules now found in Article 3 of the U.C.C. to a system in which negotiable instruments were actually used as currency would produce absurd results. For example, under the rules now found in Article 3, if, in *Miller v. Race*, the person from whom the Bank of England note was stolen happened to have placed a special indorsement on it, he would have been able to recover it from the party into whose hands it came. That would be roughly equivalent to permitting someone to write "This is mine" on a ten dollar bill and thereby ensure recovery, if the bill was stolen, from any remote party into whose hands it came.

Indeed, the fact that negotiable instruments law has evolved away from the "once bearer paper, always bearer paper" system of the common law to the present

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84. N.I.L., *supra* note 2, § 40 at 722; W. E. BRITTON, *supra* note 2, § 63 at 245–46.
85. N.I.L., *supra* note 2, § 9(5) at 715; W.E. BRITTON, *supra* note 2, § 64 at 247–50.
86. N.I.L., *supra* note 2, § 9(5) at 715; W.E. BRITTON, *supra* note 2, § 64 at 247–50.
87. W.E. BRITTON, *supra* note 2, § 64 at 247.

rules of Article 3 in which all turns of specific actions taken by the parties is strong evidence of the essential irrelevance of the Article 3 rules. The present Article 3 rules permitting instruments to be switched back and forth from bearer to order paper have a lovely internal symmetry and order, but they are utterly unsuited to any actual system of commercial practice. The legal system can tolerate the present Article 3 rules only because there simply is no commercial practice to which they apply now that the era of hand to hand circulation of privately issued instruments as a form of currency has long passed into history.[88]

Although there no longer is any commercial practice of hand to hand circulation of negotiable instruments in bearer form as a form of currency, investment securities issued in bearer form are still transferred from person to person as investment vehicles.[89] The transfer rules for such instruments, however, bear out the argument that the choice between the application of the bearer paper system and the order paper system should turn on the nature of the instruments and the system in which they are typically used, rather than on specific acts of parties who handle them. Article 8 of the U.C.C. provides that a security is in bearer form if "it runs to bearer according to its terms and not by reason of any indorsement."[90] Accordingly, neither a person who purchases a bearer bond nor the issuer who pays it need worry greatly about any special indorsements that might have been placed on the security because under Section 8-302, a purchaser "who takes delivery of a security in bearer form" can qualify as a "bona fide purchaser" who takes free from adverse claims.[91] The

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88. Evidently, the drafters of Article 3 would have agreed. The first draft of Article 3 continued the rule of the N.I.L. that an instrument originally in order form and then indorsed in blank remained ever after in bearer form despite any subsequent special indorsement. AMERICAN LAW INSTITUTE, COMMERCIAL CODE ARTICLE 3 § 24 at 27 (Tent. Draft No. 1 1946). The present rule of U.C.C. § 3-204(1) appeared in the next draft, COMMERCIAL CODE ARTICLE 3 § 33 at 48-49, (Tent. Draft No. 2 1947), with the following explanation for the change:

> *Special indorsement of bearer instrument.* This involves a question of no particular importance which has been in controversy ever since the Original Act was drawn. The original section 40, together with the wording of the original section 9, left in some doubt the question whether an instrument drawn payable to bearer and specially indorsed remains payable to bearer or requires further indorsement. In Parker v. Roberts, (1922) 243 Mass. 174, 137 N.E. 295, the only case dealing with this question, it was held that the indorsement of the special indorsee was necessary.
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> Both the Institute and the Commissioners have disagreed over the question. In favor of requiring the indorsement of the special indorsee it is contended that the special indorser as the owner of the paper should have the right to direct the payment, and to require the indorsement of the special indorsee as a receipt, and that without such indorsement no one can safely purchase or pay the instrument, since he has notice of a possible claim of the special indorsee. Against this it is contended that if the holder can control the method of negotiation he can force upon the maker the risk of payment under a forged or unauthorized indorsement, a risk which the maker did not contract to assume; and that banking practices have been established on the basis that paper drawn payable to bearer may be paid to the holder without regard to indorsements. *See* Turner, *A Factual Analysis of Proposed Amendments to the Negotiable Instruments Law*, (1929) 38 Yale L.J. 1047.
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> The question is certainly of little practical importance as it seldom arises. The Council have voted in favor of the simple solution, that the indorsement of the special indorsee is always required, even on bearer paper. The Reporter believes that this is the desirable rule.

COMMERCIAL CODE ARTICLE III, Notes and Comments to Tentative Draft No. 2, Article III, at 49-50 (1947).

89. The extent of circulation of securities in investment form, however, will presumably diminish rapidly in light of the recent changes in federal tax law. *See supra* notes 79-80 and accompanying text.

90. U.C.C. § 8-102(1)(d).

91. U.C.C. § 8-301(2) (A bona fide purchaser in addition to acquiring the rights of a purchaser also acquires the security free of any adverse claims).

Certain writings on the instrument may, though, give notice of claims precluding a purchaser from qualifying as a bona fide purchaser. *See* §§ 8-310(indorsement in bearer form) and 8-304(1)(a) (restrictive indorsements such as "for contrast between the elegant, but irrelevant, formalism of Section 3–204, and the simple practicality of Section 8–102(1)(d) is striking. It is all well and good to establish rules on the basis of their intellectual aesthetic appeal if the rules need never actually be applied; but in circumstances in which there really is a commercial practice of transfers of instruments in bearer form, it simply will not do to switch back and forth between two diametrically different sets of transfer rules. Rather, the choice of the applicable rules must be made systemically, on the basis of the needs of the type of transaction involved.

The recognition that the rules for bearer paper and order paper are entirely separate systems also provides the basis for resolving the anomaly that the principal effect of the rules of negotiable instruments law in most modern transactions is to ensure that transferees of negotiable instruments will take subject to, not free from, adverse claims of ownership. If negotiable instruments in order form were in fact passed from person to person, the negotiable instruments rules would be a horrendous system of title recognition. In fact, however, in the actual commercial practices in which instruments in order form are used, transfers from person to person are quite atypical, and the principal effect of application of the order paper rules is to throw the risk of theft and fraud losses onto the financial institutions that process the transfers of the rights represented by the instruments. This can be seen by examination of the typical uses of the two most common forms of instruments in order form: registered securities and checks.

Investment securities in registered form are, of course, frequently and rapidly traded. The mechanism for effecting transfer of ownership of such securities, however, does not involve passing around a certificate with a string of indorsements on the back. Rather, a given certificate is typically transferred only once, from seller to buyer, and then is surrendered to the issuer or its transfer agent for registration of transfer and issuance of a new certificate. Although the purchaser faces some risk of subjection to potential adverse claims of the immediately prior owner, that is generally only a temporary risk because as soon as the transfer is registered the issuer's wrongful registration liability takes the place of the purchaser's conversion liability. Thus, the purchaser need not fear subjection to remote adverse claims for the simple reason that the certificates are not passed around but are typically surrendered and reissued with each transfer. On the other hand, the owner's rights are fully protected by virtue of the issuer's liability for wrongful transfer.

Similarly, although checks are typically drawn in order form, the application of the order paper rules to checks does not have the effect of subjecting ordinary users of checks to risks of loss from forgery or theft. Checks are not typically passed about from party to party by indorsement. Rather, in the ordinary use of checks, the payee immediately deposits it for collection at a bank. Accordingly, although it is true that one who takes a check through a forged indorsement faces liability to the true owner of the check, the only party who is likely to take a check through *any* indorsement

collection"); § 8–304(1)(b) ("unambiguous statement that [security in bearer form] is the property of a person other than the transferor").

will be a collecting bank. Thus, the effect of the application of the order paper rules in the check system is to ensure that the providers of the payment system rather than the users of the payments system will bear the risk of forgery and fraud.[92]

In the systems of commercial practice to which the order paper rules actually apply, such as transfers of registered securities and the check system, the writings used play a role quite different from bearer instruments. Negotiable instruments in bearer form, such as investment securities in bearer form or the private currency of the era of *Miller v. Race* and *Peacock v. Rhodes*, are in a very strong sense reifications of the abstract rights that they represent, that is, the rights to payment represented by bearer instruments are bound up in the writings themselves. Ownership of the underlying right depends on possession of the writing, and transfer of the underlying right requires, and is completed by, transfer of the writing. Thus, the writings themselves are the critical element of the title recognition system.

By contrast, the order form instruments used in the checks system and the registered securities system function less as embodiments of the underlying rights than as instructions to the banking or securities transfer systems concerning the transfer of funds or investments. Transfers of ownership of stock are completed not by passing around certificates but by registration of the transfers on the books of the issuers.[93] Similarly, transfers of bank credit in the check system are effected not by passing around checks, but by a series of account entries among the banks involved in the collection and payment of the checks. The role of the writings used in these systems is to direct, not effect, the transfers. The critical element of the title recognition system for such transactions is not the writings themselves, but the records of the financial institutions that process the transfers. The writings themselves only play the auxiliary role of directing the transfers actually effected by entries on the records of the financial institutions.

Although the order paper rules of negotiable instruments law are poorly suited to systems in which the writings actually embody the underlying rights and actually are transferred from person to person, they happen to yield entirely sensible results when applied to systems such as the registered securities transfer system or the check system in which the writings are used as transfer instructions. In these systems, the effect of the rule that no one can acquire "good title" to an instrument through a forged or unauthorized indorsement is not to render uncertain the title of persons dealing with the instruments as items of property, because no one is really doing that. Rather, the effect of the rule is to ensure that the financial institutions will effect only those transfers that are in fact authorized. A depositary bank faces liability for collecting a check over a forged indorsement not because it has in any literal sense converted an item of property belonging to another, but because the drawer of the

92. The argument that negotiable instruments law is essentially irrelevant in the law of the check system, and that the law of the check system is best understood by focusing not on the checks as items of property but on the funds transfers that checks direct, is fully developed in Rogers, *The Irrelevance of Negotiable Instruments Concepts in the Law of the Check-Based Payment System*, *supra* note 5.

93. To be sure, a transferee of a security in registered form acquires an interest therein upon delivery of the certificate § 8–313(1)(a); however, the transferee does not acquire assurance of title until registration of tranfer. *See supra* notes 67–73 and accompanying text.

check had not authorized a transfer of funds to the person to whom the bank gave the money. Similarly, an issuer faces liability for transferring a registered security on a forged indorsement not because it has converted the true owner's property but because the true owner had not in fact authorized the transfer. The application of the order paper rules of negotiable instruments law to checks and registered securities, then, is simply a mechanism for implementation of the principle that those who maintain the actual records of the transfer system bear the risks of unauthorized transfers.

The failure to approach the choice between the bearer paper rules and the order paper rules systemically may well yield seriously unjust results. Consider, for example, the rights of a payee of a check when the check is stolen. Under the Article 3 rules, the outcome is dramatically different depending on whether the check was in order form when stolen, so that the thief had to forge the payee's indorsement, or had been converted to bearer form by the payee's blank indorsement before it was stolen. The careful payee who leaves a check in order form until the moment of deposit faces no risk of loss through theft, while one who carelessly indorses a check in blank and leaves it lying around faces the risk that, if it is lost or stolen, it may come into the hands of one who qualifies for holder in due course status. If nothing else, we all expect commercial law students to learn this basic lesson: "So, dear students, you can now see why you should never indorse a check in blank, except at the moment of depositing it at your bank."

There is, in fact, a cruel irony in that bit of advice. As is often noted, the principal significance of the bearer paper rules of negotiable instruments law is that it is possible for an individual to become a holder in due course of a bearer instrument even if that individual takes through a thief. Application of bearer paper rules to checks would make sense only if it is important that the holder in due course principle be applicable to checks. Isn't it then a bit odd to proclaim in one breath that it is essential to the functioning of the system that checks be regarded as negotiable instruments so that people can attain holder in due course status and then in the next breath to advise users of checks to be careful that they do not conduct their affairs in such fashion that the holder in due course rules may come into play? If, as is plainly the case, there is no commercial practice calling for the hand to hand circulation of checks in bearer form, then there is no occasion for application of the bearer paper rules to checks, regardless of the particular words that the payee happened to have written on the check. The Article 3 rules that result in displacement of the order paper rules for checks by virtue of the form of indorsement are nothing but a trap for the unwary.[94] To be sure, there may be good reasons for adopting rules that preclude payment system users from recouping unauthorized transfer losses from payment system providers in certain circumstances in which the user's carelessness contributed

94. Note, too, that this trap for the unwary is all the more cunning by virtue of the fact that it is customary—though not at all essential—to indorse checks in blank when depositing them for collection, and that the mechanism of restrictive indorsement "for deposit only" enables a payee to do so without facing any of the risks that would otherwise flow from converting the instrument into bearer form. Thus, the only person who could be trapped by the rule is one who neglected to add the words "for deposit only" before indorsing the check.

to the loss.[95] The only reason, though, that indorsing a check in blank strikes us as that sort of carelessness is that we have—for no other good reason—a rule that one who loses a check in such form bears the loss.

VI. Conclusion

The starting point of this Article was the usual lawyers' assumption that negotiable instruments are a very special form of property because the law provides greater protections to bona fide purchasers of negotiable instruments than to purchasers of any other form of property and that this special protection is essential to those transactions in which negotiable instruments are used. The conclusion is that this is exactly backwards: the most important aspect of negotiable instruments law in the modern world may well be the rules of the order paper system that have the effect of ensuring that the rights of owners of abstract rights represented by negotiable instruments cannot be cut off by bona fide purchasers of the instruments. The real lesson, however, is that talking about owners and purchasers of negotiable instruments is often misleading. In order to understand the role of negotiable instruments law, one must constantly bear in mind that what matters is not the instruments themselves, but the abstract rights represented by the instruments, and that the objective is to design an effective system of title recognition for the abstract rights. The negotiability system of title recognition itself, that is, the system embodied in the bearer paper rules, proves, on careful examination, to be a fairly poor system: it accomplishes the objective of providing assurance of title to purchasers, but does so not by providing a mechanism for discovering adverse interests, but simply by wiping them out. For that and other reasons, there seems to be a general tendency to evolve away from the negotiability system in favor of various formal or informal systems relying not on possession of the instruments but on the records of financial institutions. In such systems, the only point to classifying the writings used as negotiable instruments is that it happens that the order paper rules of negotiable instruments law can be applied to implement the principle that those who maintain the transfer system must honor the instructions of those who use the system.

95. *See* U.C.C. §§ 3–406, 4–406.